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The True Distortions in the With Profits Market

"If disclosure is not the problem, then more information is not the answer"

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Summary

The Financial Services Authority's review of With Profits policies has been motivated by a perception that consumer understanding of these products is insufficiently developed. This paper suggests that these concerns have not so much been overstated as misguided. With profits policies are complicated but consumers don't need to understand them.

Their merits need restating. Recent research has concluded that perhaps the majority of households actually hold their mortgage debt for longer than previously thought. This adds weight to the view that equity-backed mortgages are the most suitable repayment vehicles. Because with profits endowment policies (the majority of with profits policies) expose savers to the higher returns from the stock market while minimising the risk of temporary underperformance, they therefore represent a particularly beneficial package for a surprisingly large cohort of the financially unsophisticated, home owning population. This simple truth appears to be getting lost in the debate about their complexity and opacity.

In fact the criticisms of with profits products are simply missing the point. It is not the complexity of the products that leads to distortions in the market but their low surrender values. Comparing with profits policies with the markets for automobiles and prescription medicines, to take two examples, illustrates the fatuous nature of the idea that consumers need much greater disclosure than at present. Rather consumers need information about the quality of the providers and the intermediaries. Automobiles and prescription medicines are far more complicated than with profits policies. Yet in the automobile industry the manufacturer's reputation is sufficient to ensure that the vast majority of consumers do not need to know the technical specifications of model A versus model B. And similarly it is sufficient for most patients to know that their Medical Practitioner recommends a particular prescription medicine. For consumers of financial products, it is the reputation of the provider and intermediary that are of paramount importance in product selection. While greater efforts on behalf of providers may enhance consumer understanding, there must be strong doubts about whether this would actually increase consumer welfare. Disclosure is not the problem, so more information is not the answer.

The real problem is that the costs to consumers of being locked into a contract are too high. Because providers have moved to the front-loading of charges, the surrender value of policies in the early years is far below the investment value of whatever funds have been invested. Very low surrender values lead to very high switching costs, and so consumers whose circumstances change or who lose confidence in their provider are left with little alternative either to cease completely or to continue reluctantly with what might be their principal form of savings. The FSA ought to consider methods of ensuring that consumers are able to switch policies at low cost. With reasonable assumptions about normal competitive behaviour, this alone would eliminate the worst distortions to the with profits market.

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I. Introduction

The Financial Services Authority has recently and in quick succession undertaken a review of pensions, a somewhat heavy-handed and critically pre-disposed survey of endowment policies, and now the With Profits Review. While the earlier investigations were motivated first by legitimate grievances over pensions mis-selling and second by confusion over diminishing endowment returns in a low inflation regime, the current review is motivated primarily by a perception that consumer understanding of with profit policies is insufficiently developed. (FSA 2001a; FSA 2001b) In particular the review has been directed to focus on six related sub-projects:

- transparency and policyholder communications,
- unfair contract terms,
- governance and discretion over the operation of with profits funds,
- disclosure to customers and regulatory reporting,
- inherited estates, and
- the interests and fair treatment of customers.

Most of these sub-projects are concerned with the information consumers receive from with profits providers. While the ownership status of orphan assets (inherited estates) is a debatable issue for the law courts to decide, and the investment practices of individual fund managers (governance and discretion) is unlikely to be of more than a passing interest to consumers, the Review’s concerns with transparency, contract terms, disclosure and fair treatment are all essentially different ways of trying to ensure that more consumers understand more about what they are purchasing.

Within the review process there has been considerable discussion about the apparent dilemma of explaining what is necessarily a very complex product to unsophisticated consumers. For instance, a recent piece of research commissioned by the Review produced what must be the most asinine conclusion of the year: that customers do not understand fully what they are purchasing. (FSA, 2002, annex B – and note that the researchers discovered that consumers were still satisfied with their with profits policies.) Needless to say the media have been full of discussion about the apparent problems of these allegedly 'outdated' with profits policies. This paper makes one simple point, that product complexity alone is not a sufficient requirement for forcing providers to move down the road to full product disclosure. Furthermore, the tangible risk to continuing with such an unstructured and poorly specified debate is that consumer confidence may be eroded and so many potential customers of with profits policies will select alternative and less suitable vehicles for saving. Let it be recalled that in 1997, before the survey of endowment policies, nearly 50% of all mortgages were backed by an endowment policy. After two years of widely publicised but ultimately unsubstantiated criticism during the equivalent review process, the market share of endowment policies had fallen to 13%.[1]

II. With Profits Policies – beneficial for whom?

The benefits of with profits policies need to be restated. They are three-fold.

1. The principal reason why they exist is because for long term savers equity-backed investments generate a higher return than alternatives
2. With profits policies smooth otherwise volatile stock market returns
3. With profits policies offer a set of guaranteed returns at maturity and at death.

Equity backed savings policies

The majority of with profits policies are endowments. Most potential consumers of with profits endowment policies are home-owners wanting to use a high value vehicle to repay their mortgage. That equity-backed repayment vehicles are particularly suitable for this group has been underlined by recent research that suggests that perhaps half of all mortgagors actually remain indebted for longer than the industry's standard twenty-five year product term. (Godley, 2002) This initially may seem surprising, or counter-intuitive, given the popular perception that the day of the final mortgage payment is a significant lifetime event. But recent developments in the economic theory of consumer behaviour suggest that many households may extend the terms of their repayment periods as needs-based expenditure increases temporarily. (See Muellbauer, 1999 for a recent survey.) In a world where many households may select to reduce monthly mortgage repayment premiums in order to, say, better afford university fees or a step up the

[1] FACT, 2000, p. 16. This outcome may of course be multicausal.

housing ladder, household mortgage indebtedness may well last significantly longer than twenty-five years. There is nothing sacrosanct about twenty-five years as the upper limit to the repayment period, at least in theory.

In reality we don't actually know how long people take to repay their mortgage, for there is little research on debt management strategies among home owners. A recent study of a sample of mortgage applications in the South East of England suggested that among those house owners trading up (or nearly three quarters of the total), fully 71% extended their repayment periods leading to an average increase over the whole population of 2.0 years, from 25.0 to 27.0 years. Despite the additional period of borrowing and saving being only two years, because of compound growth rates on the capital sums invested, an endowment policy would outperform a straight repayment policy by around 20% for this cohort of borrowers. (Godley, 2002)

Mortgage borrowers have been for many years the largest single group of with profits endowment policy consumers, and so these results need emphasising. Because many people borrow for longer, their most suitable repayment vehicles are equity backed. Moreover, because the vast majority of mortgagors are also financially unsophisticated, the other benefits of with profits policies come into force.

Smoothing and Guarantees

While stock market returns have historically proven to outstrip any other method of saving, the underlying volatility of stock market prices means that there is always a risk at any one moment in time that the investment may be priced at a level below that required for repaying a mortgage. While the risk is linked to the term of investment (so that the risk of underperformance is lower for those who actually borrow for longer than twenty-five years), the risk is never removed. (Godley, 2002) For the risk averse and/ or financially unsophisticated the advantage of a with profits policy is that providers 'smooth' the profits over time, so reducing the risk to consumers from stock market volatility. This, along with setting minimum guarantees to the eventual capital sum on maturity and at death, means that with profits policies are designed to combine attractive rates of investment growth with minimising the risk of any temporary underperformance of the underlying assets, and with the security of knowing that the required amount will actually be paid. This makes them ideal products for the relatively cautious and financially unsophisticated. This is especially so for any first time borrowers who might at some stage want to trade up and extend the term of their mortgage. With profits policies are in other words ideally suited to those young couples buying their first property who may want to start a family and then, at some stage in the future, may want to move into a larger family house. Because of the increase in the costs of dependents just at the time of trading up, many in this cohort may well prefer to reduce their monthly premiums by extending their repayment period. This is a large cohort of the total mortgage borrowing population.

Nevertheless, even if with profits endowment policies are an ideal product for very many borrowers, the combination of their fast growth and minimum risk also makes them considerably more complex to manage than, say, ordinary unit trusts.

This is the crucial difference between with profits policies and alternative vehicles such as straight repayment mortgages, for instance. With profits policies are complicated. Critics pointing to consumers' lack of understanding have accepted that the product does contain the advantage of excellent consumer value from the underlying investment performance. They just bemoan providers' inability to explain to consumers the complexity of hedging stock market volatility against, say, bond market security. Critics should note that it takes some undergraduate students of finance several years of study to grasp some of the underlying intricacies involved here! Expectations of consumers' abilities to properly understand the products need to be realistic. More importantly, however, product complexity does not necessarily mean that providers are badly failing their customers. That is because complexity is not the real issue.

III. Cars, Medicines and With Profits Policies

The economics of the with profits market is essentially very simple. A with profits policy is a complex product; but then so are many other products. Comparing the market for with profits policies with automobiles and prescription medicines, for example, illustrates the fatuous nature of the idea that consumers need substantially greater disclosure than at present in order to understand what they are purchasing.

Automobiles and prescription medicines are technically far more complicated than with profits policies, yet consumers make almost no attempt to understand them in any detail.[2] Rather when purchasing an automobile, the competing manufacturers' reputations are sufficient to ensure that the vast majority of consumers do not feel the need to know the technical specifications of model A versus model B, even if they had the engineering competence. And similarly it is sufficient for most patients to know that their Medical Practitioner recommends a particular prescription medicine. The medical knowledge required to correctly interpret the information about competing prescription medicines is far beyond the average patient's education.

In principal a similar logic should apply to complex savings instruments. Consumers ought to be more interested in the reputations of the provider and intermediary rather than in the mechanics of swaps and futures markets. And in fact, as successive surveys show, this is exactly what is of paramount importance to consumers making their selection decisions. (FSA, 2002, para. 16) Furthermore, the specific items of information that consumers say they require are actually quite modest. Consumers say that they need clear information on the current value of their investment, projected or target value, and the guaranteed value on death. (FSA, 2002, para. 17) And while some providers do appear to do their best to obscure this in the annual statements, it would not require an enormous investment in upgrading disclosure procedures to disseminate this information more clearly. Beyond this limited amount of greater clarity, there is apparently little additional information that most consumers actually want. There must in other words be very strong doubts about whether any substantial increase in product disclosure to consumers would actually lead to any significant gain either in consumer understanding of the product or,

[2] As are any number of other products and services: utilities (gas, water, electricity), metals production, mining, and of course new information technology products, as well as many others. Cars and medicines are used here simply because of their ubiquity, and hence our familiarity with their complexity.

more importantly, in consumer welfare. If disclosure is not the problem, more information is not the answer.

IV. With Profits Switching Costs are too high

In fact the real difference between consumers in the automobile or prescription medicine market and the market for with profits policies is the product commitment. If consumers of automobiles decide that the actual consumption experience was less satisfactory than the provider had promised, they can switch cars. If the patient decides that the course of treatment is not effective, then it is relatively straightforward to switch to a different therapy. In the market for with profit policies, however, the real distortion is that consumers are close to being locked into a contract when the switching costs are so high.

These switching costs (or, in the industry jargon, surrender values) are high (or surrender values are low) because providers have moved to loading their charges during the early years of the policy. Recent data published by the FSA suggests that the effect of front-loading is to reduce the return in endowments by as much as 31% in the early years. But this then falls away to only 1.5% over the product's full twenty-five year period, or the same as for ISAs and other much less complex products. (ABI, 2002) Thus the surrender values of policies in the early years are typically far below the investment value of whatever funds have been invested. But because these switching costs are so high, consumers are either locked into what appear to be unsatisfactory outcomes, or do switch but have to pay the full balance of charges in doing so.

Rather than insisting on providers producing more complete and sophisticated Key Features Documents and related product literature, the FSA ought therefore to consider methods of ensuring that consumers are able to switch policies at low cost. Just as with any other complex good or service, so consumers of with profits policies would then be able to rely on a combination of provider reputation and the counsel of a trusted advisor before making their product selection. If a consumer's circumstances then changed, or if the actual product was unsatisfactory, so a future with profits consumer could trade in the old policy for a new one; one promising faster growth, or more healthy returns. Because all providers would have to compete for customer loyalty, providing consumers with the necessary information would become an essential marketing tool in order simply to retain existing business. This reform alone would therefore eliminate the worst distortions to the with profits market.

Providers may claim that the net effect of spreading charges over the product's life would inevitably lead to higher costs and so higher charges. But the gains in welfare arising from giving consumers more direct and immediate control over their investments would easily outweigh any marginal increase in their costs.

Such a reform would not be too complicated to introduce. Establishing an acceptable benchmark for surrender values could be trivial, simply adopting a formula relating contributions to underlying fund performance with modest deductions for annual management charges, for example. FSA kitemarks could then be given to all policies that have suitably low surrender values (perhaps based on a suitably modified version of the Association of British Insurers' 'Raising Standards' quality mark). The FSA would simply need to insist that IFAs and other intermediaries have to highlight to consumers whether a product has been awarded the kitemark or not.

In conclusion, while the current With Profits Review may be driven by a consumer reformist agenda, it is clearly not driven by any coherent economic analysis of improving consumer welfare. Even the simplest view of the product and its market would conclude that complexity alone cannot justify further regulatory burdens. Indeed, the additional regulatory costs of full product disclosure may well end up pricing the product out of the market and so unintentionally doing greatest harm to precisely those the regulators seek to protect - the financially unsophisticated consumer. The principal conclusion of this paper therefore is that a more carefully specified debate about the alleged merits and demerits of with profits policies and the nature of the with profits market would inevitably produce more important results, better guided research, and ultimately more reliable conclusions.

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